

A Hypothetical Scenario

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Assume that you live in a world where

- (a) There are no taxes
- (b) Managers have stockholder interests at heart and do what's best for stockholders.
- (c) No firm ever goes bankrupt
- (d) Equity investors are honest with lenders; there is no subterfuge or attempt to find loopholes in loan agreements.
- (e) Firms know their future financing needs with certainty

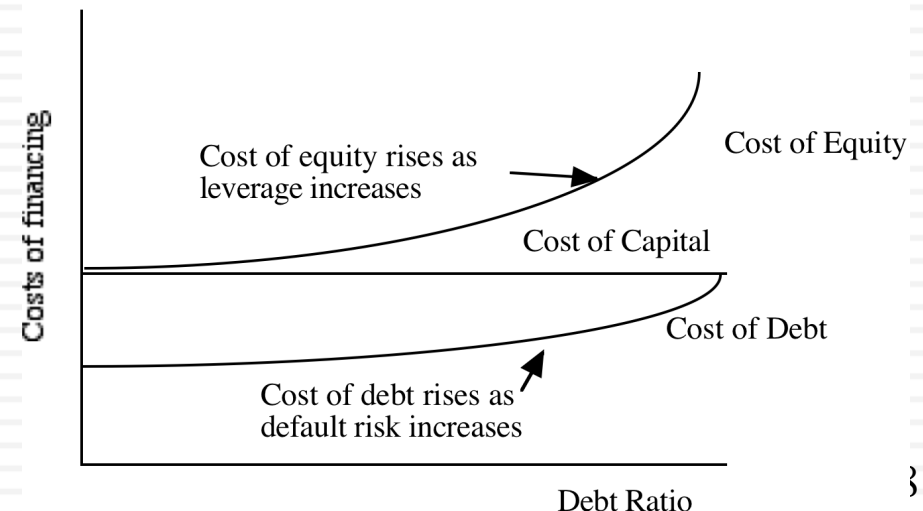
□ What happens to the trade off between debt and equity? How much should a firm borrow?

The Miller-Modigliani Theorem

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- In an environment, where there are no taxes, default risk or agency costs, capital structure is irrelevant.
- If the Miller Modigliani theorem holds:
 - ▣ A firm's value will be determined the quality of its investments and not by its financing mix.
 - ▣ The cost of capital of the firm will not change with leverage. As a firm increases its leverage, the cost of equity will increase just enough to offset any gains to the leverage.

Figure 7.9: Cost of Capital in the MM World



What do firms look at in financing?

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- There are some who argue that firms follow a financing hierarchy, with retained earnings being the most preferred choice for financing, followed by debt and that new equity is the least preferred choice. In particular,
 - ▣ Managers value flexibility. Managers value being able to use capital (on new investments or assets) without restrictions on that use or having to explain its use to others.
 - ▣ Managers value control. Managers like being able to maintain control of their businesses.
- With flexibility and control being key factors:
 - ▣ Would you rather use internal financing (retained earnings) or external financing?
 - ▣ With external financing, would you rather use debt or equity?

Preference rankings long-term finance: Results of a survey

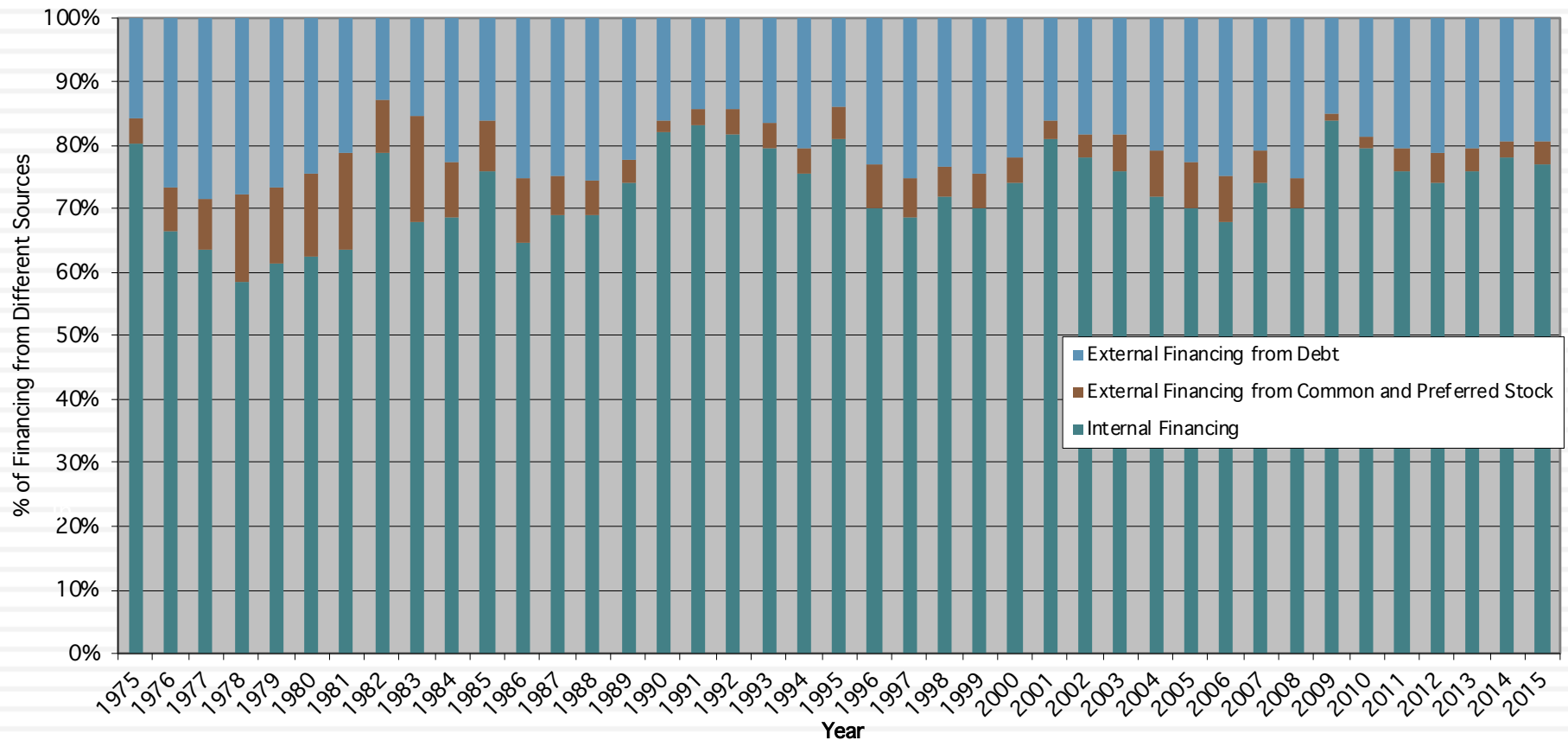
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Ranking	Source	Score
1	Retained Earnings	5.61
2	Straight Debt	4.88
3	Convertible Debt	3.02
4	External Common Equity	2.42
5	Straight Preferred Stock	2.22
6	Convertible Preferred	1.72

And the unsurprising consequences..

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External and Internal Financing at US Firms





Financing Choices

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- You are reading the Wall Street Journal and notice a tombstone ad for a company, offering to sell convertible preferred stock. What would you hypothesize about the health of the company issuing these securities?
 - a. Nothing
 - b. Healthier than the average firm
 - c. In much more financial trouble than the average firm

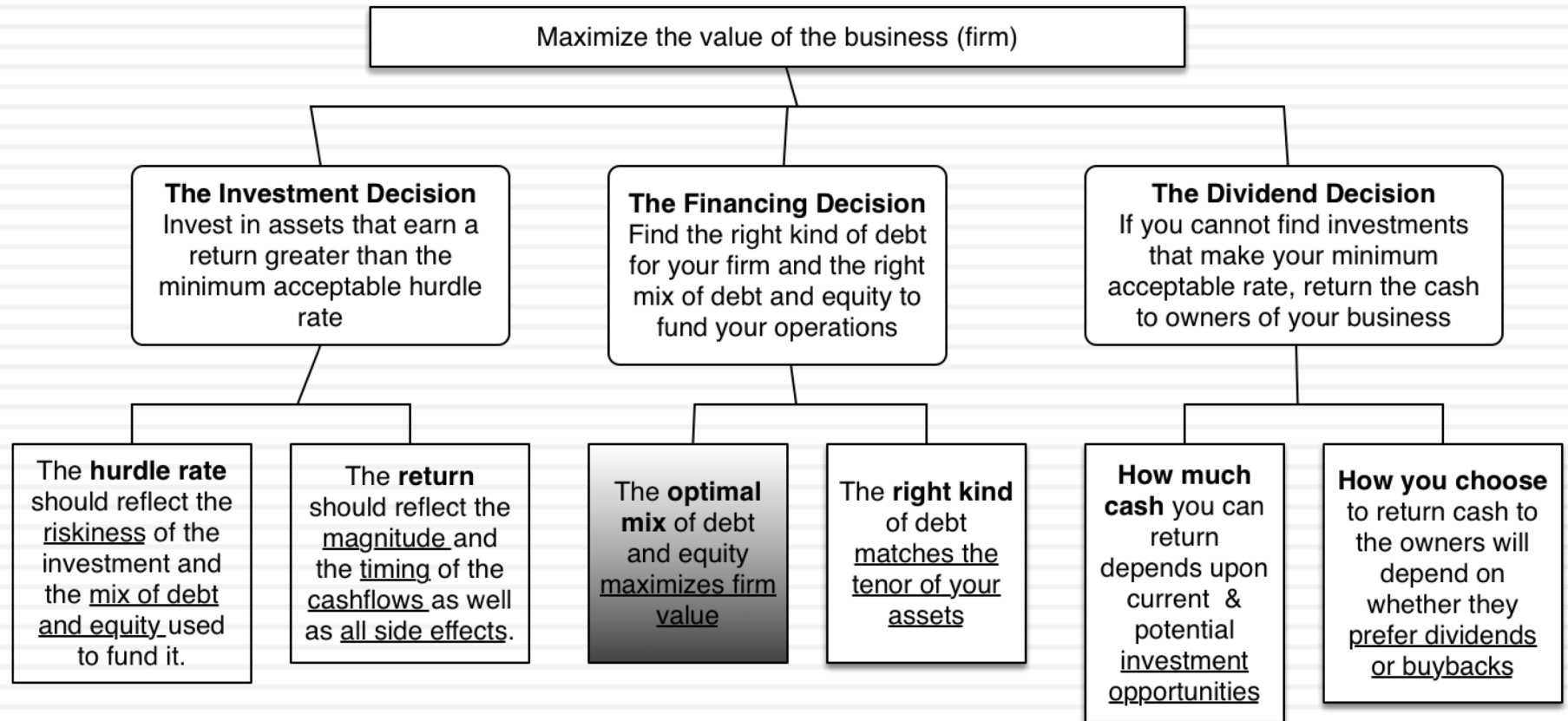


CAPITAL STRUCTURE: FINDING THE RIGHT FINANCING MIX

You can have too much debt... or too little..

The Big Picture..

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Pathways to the Optimal

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1. The Cost of Capital Approach: The optimal debt ratio is the one that minimizes the cost of capital for a firm.
2. The Enhanced Cost of Capital approach: The optimal debt ratio is the one that generates the best combination of (low) cost of capital and (high) operating income.
3. The Adjusted Present Value Approach: The optimal debt ratio is the one that maximizes the overall value of the firm.
4. The Sector Approach: The optimal debt ratio is the one that brings the firm closes to its peer group in terms of financing mix.
5. The Life Cycle Approach: The optimal debt ratio is the one that best suits where the firm is in its life cycle.

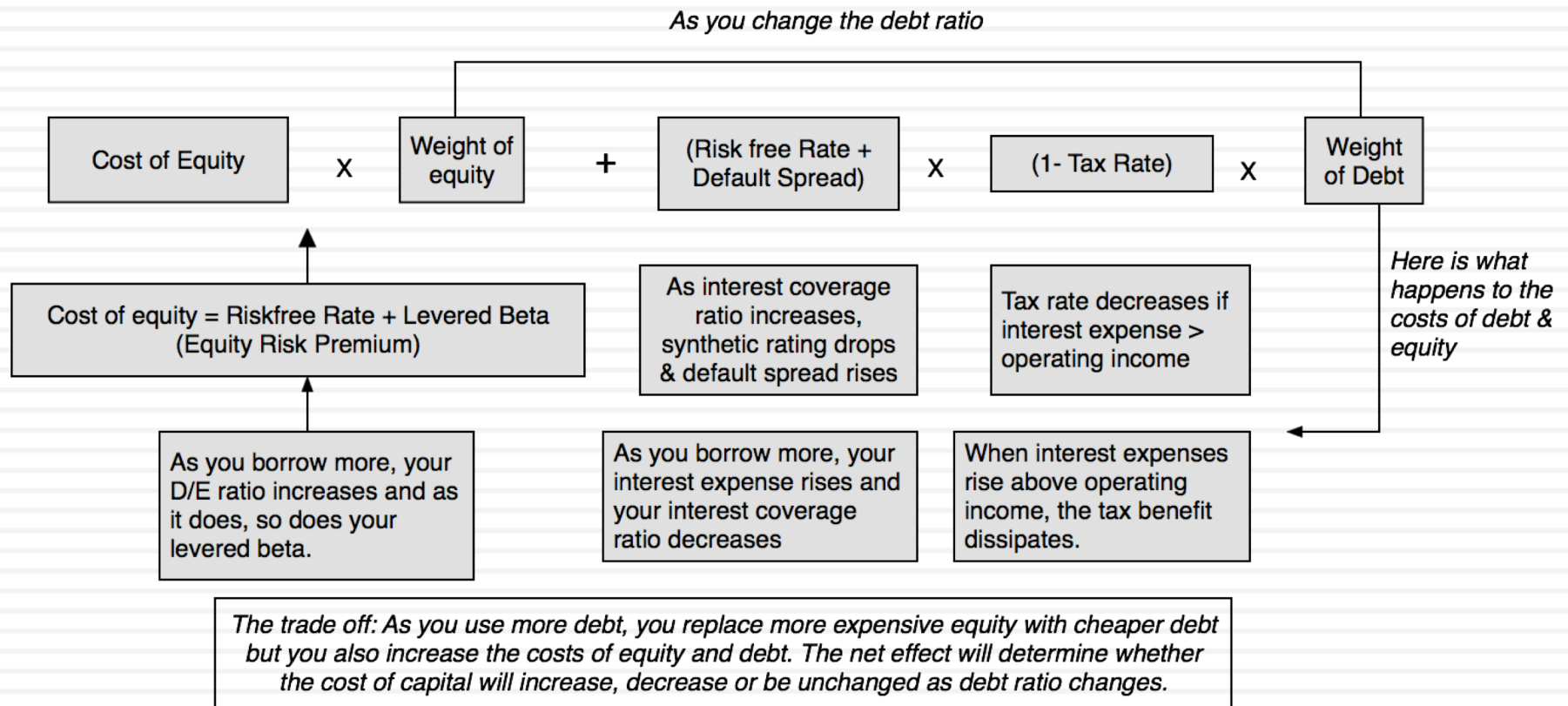
I. The Cost of Capital Approach

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- Value of a Firm = Present Value of Cash Flows to the Firm, discounted back at the cost of capital.
- If the cash flows to the firm are held constant, and the cost of capital is minimized, the value of the firm will be maximized.
- Cost of Capital = Cost of Equity ($E/(D+E)$) + Pre-tax Cost of Debt $(1 - t) (D/(D+E))$
 - The question then becomes a simple one. As the debt ratio changes, how does the cost of capital change?

The Debt Trade off on the Cost of Capital

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Costs of Debt & Equity

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- ☐ An article in an Asian business magazine argued that equity was cheaper than debt, because dividend yields are much lower than interest rates on debt. Do you agree with this statement?

a. Yes

b. No

- ☐ Can equity ever be cheaper than debt?

a. Yes

b. No

Applying Cost of Capital Approach: The Textbook Example

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Assume the firm has \$200 million in cash flows, expected to grow 3% a year forever.

D/(D+E)	Cost of Equity	After-tax Cost of Debt	Cost of Capital	Firm Value
0	10.50%	4.80%	10.50%	\$2,747
10%	11.00%	5.10%	10.41%	\$2,780
20%	11.60%	5.40%	10.36%	\$2,799
30%	12.30%	5.52%	10.27%	\$2,835
40%	13.10%	5.70%	10.14%	\$2,885
50%	14.50%	6.10%	10.30%	\$2,822
60%	15.00%	7.20%	10.32%	\$2,814
70%	16.10%	8.10%	10.50%	\$2,747
80%	17.20%	9.00%	10.64%	\$2,696
90%	18.40%	10.20%	11.02%	\$2,569
100%	19.70%	11.40%	11.40%	\$2,452

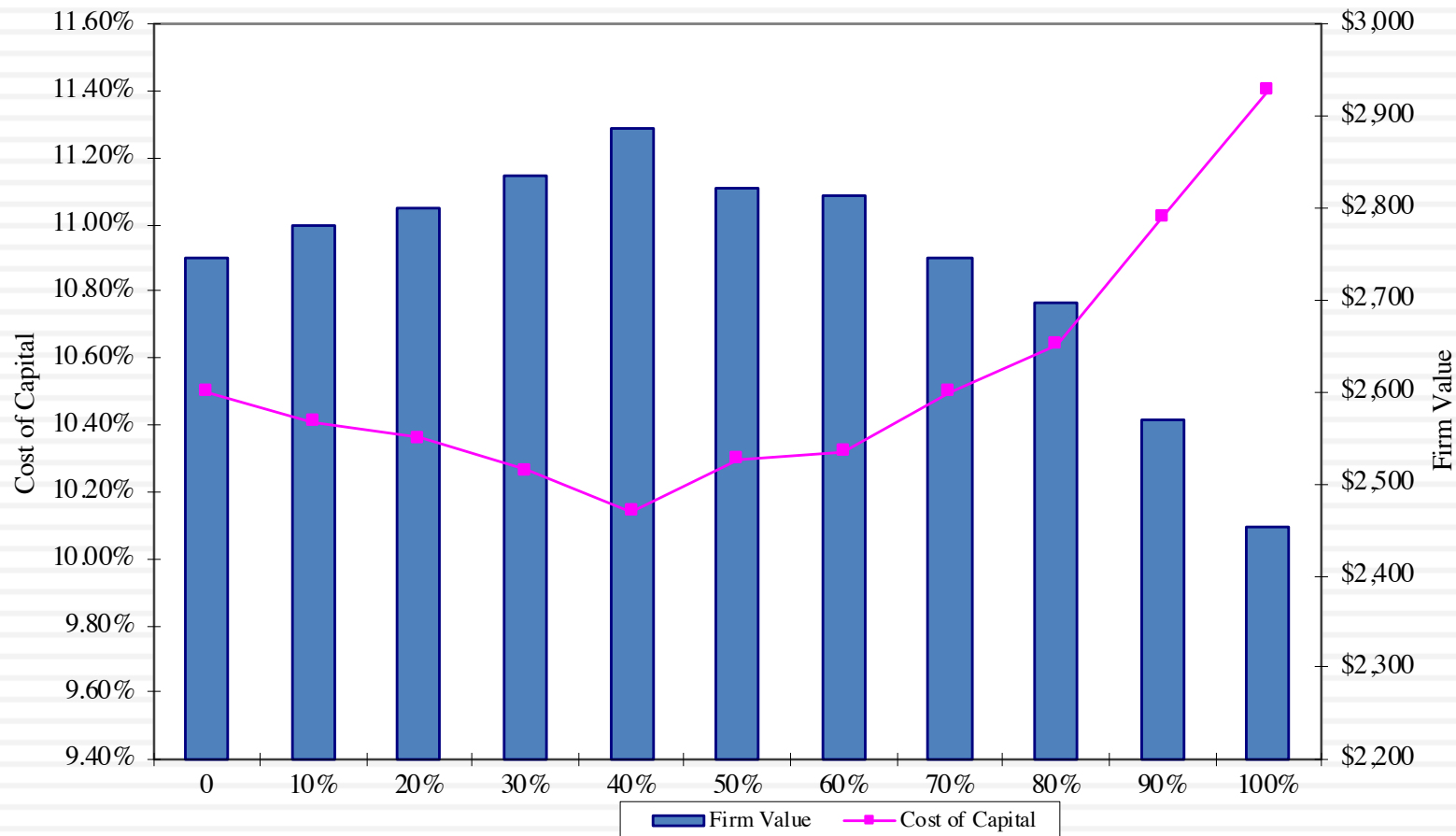
Aswath Damodaran

$$\text{Value} = \frac{\text{Expected Cash flow to firm next year}}{(\text{Cost of capital} - g)} = \frac{200(1.03)}{(\text{Cost of capital} - g)}$$

The U-shaped Cost of Capital Graph...

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Cost of Capital and Firm Value



Current Cost of Capital: Disney

- The beta for Disney's stock in November 2013 was 1.0013. The T. bond rate at that time was 2.75%. Using an estimated equity risk premium of 5.76%, we estimated the cost of equity for Disney to be 8.52%:

$$\text{Cost of Equity} = 2.75\% + 1.0013(5.76\%) = 8.52\%$$

- Disney's bond rating in May 2009 was A, and based on this rating, the estimated pretax cost of debt for Disney is 3.75%. Using a marginal tax rate of 36.1, the after-tax cost of debt for Disney is 2.40%.

$$\text{After-Tax Cost of Debt} = 3.75\% (1 - 0.361) = 2.40\%$$

- The cost of capital was calculated using these costs and the weights based on market values of equity (121,878) and debt (15,961):

$$\begin{aligned} \text{Cost of capital} = & 8.52\% \frac{121,878}{(15,961+121,878)} + 2.40\% \frac{15,961}{(15,961+121,878)} = 7.81\% \end{aligned}$$

Mechanics of Cost of Capital Estimation

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1. Estimate the Cost of Equity at different levels of debt:
 - ▣ Equity will become riskier -> Beta will increase -> Cost of Equity will increase.
 - ▣ Estimation will use levered beta calculation
2. Estimate the Cost of Debt at different levels of debt:
 - ▣ Default risk will go up and bond ratings will go down as debt goes up -> Cost of Debt will increase.
 - ▣ To estimating bond ratings, we will use the interest coverage ratio ($\text{EBIT} / \text{Interest expense}$)
3. Estimate the Cost of Capital at different levels of debt
4. Calculate the effect on Firm Value and Stock Price.

Laying the groundwork:

1. Estimate the unlevered beta for the firm

- **The Regression Beta:** One approach is to use the regression beta (1.25) and then unlever, using the average debt to equity ratio (19.44%) during the period of the regression to arrive at an unlevered beta.

$$\text{Unlevered beta} = 1.25 / (1 + (1 - 0.361)(0.1944)) = 1.1119$$

- **The Bottom up Beta:** Alternatively, we can back to the source and estimate it from the betas of the businesses.

<i>Business</i>	<i>Revenues</i>	<i>EV/Sales</i>	<i>Value of Business</i>	<i>Proportion of Disney</i>	<i>Unlevered beta</i>	<i>Value</i>	<i>Proportion</i>
Media Networks	\$20,356	3.27	\$66,580	49.27%	1.03	\$66,579.81	49.27%
Parks & Resorts	\$14,087	3.24	\$45,683	33.81%	0.70	\$45,682.80	33.81%
Studio Entertainment	\$5,979	3.05	\$18,234	13.49%	1.10	\$18,234.27	13.49%
Consumer Products	\$3,555	0.83	\$2,952	2.18%	0.68	\$2,951.50	2.18%
Interactive	\$1,064	1.58	\$1,684	1.25%	1.22	\$1,683.72	1.25%
Disney Operations	\$45,041		\$135,132	100.00%	0.9239	\$135,132.11	100.00%

2. Get Disney's current financials...

	Most recent fiscal year (2012-13)	Prior year
Revenues	\$45,041	\$42,278
EBITDA	\$10,642	\$10,850
Depreciation & Amortization	\$2,192	\$1,987
EBIT	\$9,450	\$8,863
Interest Expenses	\$349	\$564
EBITDA (adjusted for leases)	\$12,517	\$11,168
Depreciation (adjusted for leases)	\$ 2,485	\$2,239
EBIT (adjusted for leases)	\$10,032	\$8,929
Interest Expenses (adjusted for leases)	\$459	\$630